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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Access Charge Reform	)	CC Docket No. 96-262
	)	
Price Cap Performance Review For Local Exchange Carriers	)	CC Docket No. 94-1
	)	
Tariffs Implementing Access Charge Reform	)	CC Docket No. 97-250
	)	
Consumer Federation of America, International Communications Association and National Retail Federation Petition Requesting Amendment of the Commission's Rules	)	RM No. 9210

COMMENTS

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Date: October 26, 1998

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COMMENTS

BellSouth Corporation and BellSouth Telecommunications Inc. ("BellSouth) hereby submit their comments on the Commission's Public Notice that seeks to refresh the record in the above referenced proceedings.[1]

I. INTRODUCTION AND SUMMARY

In its Public Notice, the Commission identified several open proceedings in which it is addressing matters that relate to the way the Commission regulates incumbent local exchange carriers ("LECs"). Accordingly, the Commission seeks to refresh the record on the proper level for the X-factor, whether the Commission should implement a prescriptive approach for access charges and the form of any pricing flexibility the Commission should grant incumbent LECs.

[1] Commission asks parties to update and refresh record for Access Charge Reform and seeks comment on proposals for Access Charge Reform Pricing Flexibility, CC Docket Nos. 96-262, 94-1, 97-250, RM-9210, *Public Notice* (FCC 98-256), released October 5, 1998 ("Public Notice").

With regard to the X-factor, USTA is providing the Commission with updated productivity analyses. BellSouth has worked closely with USTA in the development of these analyses and fully supports and concurs in their results.

A particularly troubling fact is that the Commission has not quickly disposed of the requests made earlier this year by MCI and the Consumer Federation of America ("CFA") that it abandon its market-based approach in favor of a prescription of access rates at some measure of incremental costs. The Commission has over seven years experience with price cap regulation in which there is clear and incontrovertible evidence that incentive-based regulation has provided superior market performance and served the public interest better than would otherwise have occurred under traditional, cost-plus systems of regulation.[2]

The Commission continues to be asked to ignore this experience and instead embrace the precept that only rates set at incremental cost are just, reasonable and competitive. What is presented as the new orthodoxy is merely recycling old regulatory dross. The facts show that price cap regulation has resulted in lower prices, increased efficiency and substantial infrastructure investment. All of these results are important Commission objectives that could not have been realized under traditional forms of regulation including prescribing rates at incremental costs.

Further, completely overlooked is that price-cap regulation is a starting-point for a market-based system of regulation. It was adopted not because competition was in place but instead because of its absence. The Commission found that price cap regulation better emulated the outcome that would be produced by a competitive market. Thus, the argument that the

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[2] *See, e.g.,* In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, *First Report and Order*, 10 FCC Rcd 8961 (1995).

Commission should abandon price-cap regulation for a prescriptive approach because competition has not grown is nonsensical.

Further, it is irrational to impose an incremental cost pricing standard on LECs in the name of emulating a competitive outcome. Economic evidence suggests that non-regulated, competitive firms when faced with significant fixed costs, such as those that characterize the telecommunications industry, systematically set their prices in excess of marginal costs. Permitting market forces to determine the manner in which shared and common costs are recovered results in a set of more efficient prices than would occur by the Commission arbitrarily dictating the allocation of such costs to services through a cost methodology (such as total service incremental costs).

Competition continues to grow. The challenge for the Commission is to bring its regulations in line with competitive developments. The Commission has failed to take any steps that would relax regulation. This hesitancy carries with it diminished market performance and a loss in economic welfare. Access charge reform must address the failure of the regulatory process to keep pace with the changes in the marketplace. Consumers are entitled to high quality services at competitive prices. Incumbent LECs ought to have the flexibility to deliver such services to the marketplace.

II. PRESCRIPTION OF ACCESS RATES IS UNNECESSARY AND CONTRARY TO THE COMMISSION'S EXISTING POLICY OF INCENTIVE REGULATION

The recent spate of calls for the Commission to "prescribe" access charges at forward-looking incremental costs is fundamentally inconsistent with the Commission's policies and goals to promote competition, innovation, new technologies and consumer choice. The mantra that price must equal forward-looking incremental costs portrays this single outcome as the simple means for the Commission to meet its responsibilities under the Communications Act.

This one step suddenly becomes the answer to the Commission's entire regulatory conundrum. Armed with this single idea, the Commission is supposed to undo the progress it has made to reform regulation and take a giant step backward in time and reinitiate a failed cost-of-service based form of regulation.

While retro-music, clothes and cars may be chic, retro-regulation is not the way to establish public policy or the proper foundation for telecommunications in the 21st century. The Commission has recognized that its challenge is to harness the economic power of the marketplace and to permit the marketplace to be the engine of change and advancement in the telecommunications industry. This understanding pre-dates the passage of the Telecommunications Act of 1996 and with the Telecommunications Act's emphasis on deregulation, confirms that the Commission's choice of a market-oriented regulatory approach.

A. Incentive Based Regulation Has And Continues To Serve The Public Interest

In 1991, the Commission took a bold step by abandoning its traditional approach to regulating local exchange carriers and adopted price cap regulation. Price cap regulation replaced the conventional rate-of-return or cost-plus system of regulation with an incentive-based price cap system. With price cap regulation, the Commission sought to replicate the beneficial incentives of competition in the provision of access services, striking a reasonable balance between the interests of ratepayers and stockholders. As the Commission explained, "[p]rice cap regulation is intended to encourage growth in productivity by permitting incumbent LECs that increase their productivity to earn higher profits while at the same time ensuring that interstate access customers share in the benefits of productivity growth in the form of lower rates."[3] Thus, the Commission fundamentally redefined the regulatory paradigm for local exchange carriers and implemented a system that ensured that both carriers and customers would be better off.[4]

Price cap regulation, by incorporating profit-making incentives that are common to all non-regulated businesses, produces a set of outcomes that advance the public interest. Thus, this system of regulation results in just, reasonable and nondiscriminatory rates to consumers as well as an environment that fosters investment in the telecommunications infrastructure that is essential to the provision of innovative, high-quality telecommunications services. The past price cap reviews have recognized that the promise of incentive-based regulation has been realized.

Incentive-based regulation has played an important role in achieving the public policy goals of the Commission. The beneficial results that have been realized by both consumers and carriers could not have been obtained under a traditional cost-plus system of regulation. The Commission recognized early on that moving away from rate-of-return regulation to incentive-based regulation "replicates more accurately than rate of return regulation the dynamic, consumer-oriented process that characterizes a competitive market."[5] By breaking the direct link between prices and earnings, the price cap system of regulation blunted the perverse incentives

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3 *In the Matter of Price Cap Performance Review for Local Exchange Carriers and Access Charge Reform*, CC Docket Nos. 94-1 and 96-262, Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262, 12 FCC Rcd 16642, 16645-6, (1997) ("Fourth Report and Order").

4 *Id.*

5 *In the Matter of Policy and Rules Concerning Rates for Dominant Carriers*, Report and Order and Second Further Notice of Rulemaking, 4 FCC Rcd 2873, 2893 (1989).

associated with cost-plus regulation.[6] The public is protected against unreasonable prices in that price regulation establishes maximum aggregate prices for groups of services, yet carriers have the discretion to adjust prices easily as long as prices remain at or below the cap—an essential element for the development of true competition.

The Commission in its price cap reviews has confirmed the benefit of price cap regulation. While the Commission adopted changes to the LEC price cap plan, the fundamental precepts regarding the superiority of incentive-based regulation went undisturbed. Not to be overlooked is the fact that the Commission found price caps a superincumbent form of regulation not because competition was in place but rather because price caps better emulated the outcomes that a fully competitive market would produce. Thus, justification of price cap regulation lies not in the presence of competition, but instead in its absence. Indeed, the presence of effective competition justifies the relaxation and elimination of price cap regulation.

Price cap regulation has provided the public with the benefits that the Commission anticipated. Since price cap regulation was implemented in 1991, access prices have decreased by $11 billion nationwide. For BellSouth alone, access reductions have provided approximately $2 billion in ratepayer savings. From 1991 to 1998, BellSouth's composite switched access rate has declined from $.057 to $.040.[7] Nonetheless, BellSouth continues to invest significant amounts in the network infrastructure. In each of the last two years, BellSouth invested $3.5 billion in its local network. These are the very outcomes that price regulation is intended to

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6 Under traditional rate-of-return and its derivative cost-of-service regulation, cost inefficiencies and cost-shifting were means for achieving additional earnings. Incentive-based regulation not only does not reward such market behavior, but in addition, deters such behavior because carrier profits would actually decrease.

7 The 1998 composite rate includes amounts associated with Primary Interexchange Carrier Charges.

create. Consumers benefit from lower prices while at the same time carriers are provided sufficient profit incentives[8] to maintain their commitment to infrastructure development.

Price cap regulation is the starting point of a market-based regulatory paradigm—not the ending point. It results in superior market performance because cost-of-service based regulation is unidimensional. Unlike a market-based approach to regulation, a cost-of-service, prescriptive approach fails to accommodate the interaction of complex economic relationships that dictate market behavior and performance. Among the economic factors that influence an industry participant's conduct are the amount of capital investment that is required, the rate of technological change, market demand, and the ability to respond to new revenue producing opportunities. The interaction of these factors creates a dynamic marketplace. The telecommunications market is characterized by rapid technological change that in turn increases the risk of the substantial capital investments that a participant makes. Likewise shifting market demand (*e.g.,* preferences for specific technologies, network arrangements) increases risk and requires a regulatory approach that enables the provider to respond to such demand changes. Price is only one parameter that influences the market. The market also demands quality, variety, reliability and responsiveness. Hence, the market equilibrium is far more complex than engaging in a game of "the price is right."

[8] Some might suggest that the earnings of Price Cap LECs are excessive and that such earnings are evidence that incentive-based regulation should be abandoned. When viewed from the appropriate perspective, it is clear that LEC earnings are reasonable. Price cap LEC returns are moderate when compared to the earnings growth of corporations overall. For example, price cap LEC earnings increased by 32% from 1990 to 1997. For the same period, earnings for 752 Value Line Industrials increased by 63%. For all U.S. non-financial corporations, earnings increased by 140%. Further, USTA's comments in response to the Public Notice demonstrates that the earnings growth of price cap LECs is attributable to gains in efficiency (and not because they possess market power). On the other hand, incentive regulation has permitted price cap LECs to be competitive with broader market investment returns.

B. The Prescriptive Approach Is Inappropriate And Inconsistent With Existing Commission Policy

There is a single focus to the prescriptive approach—to set prices that reflect a set of rules that in turn are premised upon a set of conclusions and presumptions that have been reached at a point in time. With its unidimensional emphasis on price, a prescriptive approach ignores the underlying public policy goals that are the foundation of a market-based form of regulation such as price caps.

The public interest, which the Commission is obligated to promote, encompasses parameters other than price. Indeed, the Communications Act charges the Commission to make available a rapid, efficient nationwide telecommunications network.[9] This obligation has been met by adopting policies and regulations, such as price caps, that promote innovation and investment in advanced technologies. These policies have now been embodied in Section 706 of the Telecommunications Act of 1996. Section 706 compels the Commission to seek ways in which to bring advanced telecommunications services to the public and to use market-based and deregulatory approaches to accomplish the statute's goals. A prescriptive approach is fundamentally at odds with prior Commission determinations and Congress' most recent legislative pronouncement.

A prescriptive approach is no different in effect than the cost-of-service/rate-of-return system of regulation that the Commission repudiated in its prior price cap decisions. Proponents of the prescriptive approach do not explain how prescribing rates at incremental cost levels promote new technologies, infrastructure improvements or market efficiencies. Indeed, the Commission is urged to ignore these important public interest considerations. In denominating

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9 47 U.S.C. § 151.

rate prescription as access charge reform, the Commission is supposed to believe that the matter is unrelated to the public policy goals identified in the Telecommunications Act and long embraced by the Commission.

There are several mistaken ideas that underlie the prescriptive approach. Fundamental to all is the concern that competition for access services has developed more slowly than is desirable. Based on this concern, some have erroneously argued that access prices are too high and should be reduced prescriptively. Incentive-based regulation was never predicated on an assumption that there would be a precipitous reduction of access prices to incremental costs. To the contrary, in rejecting a prescriptive approach, the Commission sought to avoid large, one-time changes in access charges, recognizing that the movement of access charges toward cost should be accomplished over a period of time.[10] Such time was also necessary to enable the Commission to remove implicit subsidies that currently distort access charges, to eliminate unnecessary regulation of competitive services, and to formulate an accurate measure of forward-looking costs.[11] All of these tasks remain to be accomplished. Further, they are prerequisites to any Commission action which intervenes in the operation of the current price cap system.

Moreover, there is no economic need or logic that compels extraordinary measures by the Commission to reduce access prices. The price cap plan, through the productivity factor, already insures that access prices are maintained at appropriate levels. The productivity factor incorporates the extent to which a price cap LEC is capable of lowering its unit costs more

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10 *In the Matter of Access Charge Reform, Price Cap Performance Review, Transport Rate Structure and Pricing and End User Common Line Charges,* CC Docket Nos. 96-262, 94-1, 91-213 and 95-72, First Report and Order, 12 FCC Rcd 15982, 16002 at ¶¶ 43-48, (May 16, 1997).

11 *Id.* at 16094-99.

rapidly than other firms in the economy. Since the cap is reduced by the productivity factor, the price cap plan replicates the pricing discipline that competitive markets impose on competitors. To reduce prices by regulatory prescription has the same affect as setting the X-factor too high. As Taylor explains in his report attached as Attachment A to USTA's comments, forcing prices below the level established by an appropriately set X-factor would mean that "an efficient regulated firm would be unable to achieve the productivity growth required so that its unit cost would fall to meet its new price."[12] All other things being equal, this outcome has the negative public policy consequence of deterring investment by the regulated firm and the negative competitive consequence of deterring entry by potential competitors.[13]

Likewise, there is no economic basis to drive prices to incremental cost. Incremental cost is appropriate as a lower price boundary below which prices should not be permitted to fall. It is not, however, a good estimate of the market price for access services in a competitive market. For example, in the case of a multiproduct firm characterized by substantial fixed costs, setting prices at incremental cost levels would be unsustainable in the long run because such prices would not permit the firm to recover all of its economic costs of production. The telecommunications industry, as a general matter, and the local exchange/exchange access market segment, in particular, are prime examples of an industry composed of such multiproduct firms.

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12 *See* USTA Comments, Attachment A, William E. Taylor, Access Reform and Pricing Flexibility in Light of Recent Developments in the markets for Carrier Access Services, National Economic Research Associates, at ¶ 37. The harmful economic consequences identified by Taylor are compounded by the fact that the current productivity factor is too high. *See* also, USTA Comments, Attachment E, Frank M. Gollop, Technical Report: Replication and Update of the X-Factor Constructed Under FCC Rules, dated October 22, 1998.

13 Taylor at ¶ 37.

Further, it makes no sense to impose an incremental cost pricing standard on local exchange carriers, in the name of emulating a competitive outcome, when economic evidence suggests that non-regulated, competitive firms when faced with significant fixed costs systematically set their prices in excess of marginal costs.[14] Permitting market forces to determine the manner in which shared and common costs are recovered results in a set of more efficient prices than would occur by the Commission arbitrarily dictating the allocation of such costs to services through a cost methodology (such as total service incremental costs).

Moreover, the Commission should be loath to adopt a prescriptive approach based on complaints that price cap regulation has not sufficiently restricted LEC earnings and therefore prices are too high. In its comments, USTA demonstrates that LEC earnings growth is attributable to gains in efficiency, an outcome specifically encouraged by and expected under price cap regulation.[15] Nevertheless, the productivity gains thus far achieved cannot be expected to continue unabated.[16] Indeed, as USTA shows, LECs will continuously be pressured to find new ways to spur productivity growth.[17] Thus, forcing rate reductions through a prescriptive approach, which would be the equivalent of increasing the LECs' productivity factor, could not likely be offset through efficiency gains and would negatively affect investment and innovation.

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[14] Taylor at ¶ 25.

[15] *See generally*, USTA Comments.

[16] *See*, Struminger and Levi, Pressures Mounting on RBOCs EPS Growth: More Evidence That Competition is in Sight (Paine Webber Telecommunication Services), May 14, 1998, who state "We estimate that approximately 30% of operating income growth in 1997 came from improvements in these areas." p. 17. They go further to state "…we do not expect to see improved operating efficiency as a major driver of earnings growth as it has been over the past three years." p. 9.

[17] *See generally*, USTA Comments.

Nor does a prescriptive approach advance competition. As discussed above, prescribing access prices at some measure of incremental cost does not equate to setting prices at competitive market levels. Such prices may well be too low to be sustainable. Accordingly, if the Commission were to force rates below competitive market levels, instead of fostering competition, the Commission's action would chill competitive entry. LEC competitors, recognizing the adverse consequences of the prescriptive approach, have expressed their concerns to the Commission. For example, Time-Warner, in opposing a Commission prescription of access rates, warned the Commission that "regulatory prescription at TSLRIC could stifle the development of facilities-based competition."[18] Indeed, Chairman Kennard has defined the Commission's task: "We are beginning to see the early, promising buds of competition. Our job is to nurture those buds, protect them from a premature frost, and to encourage even wider growth for competition..."[19] If the Commission were to revert back to a prescriptive-based approach to access rates, they would quickly freeze any competitors desire to enter the telecommunications industry. Thus, a prescriptive approach could have serious anticompetitive consequences.

C. Competition Continues To Develop

There are some who would urge the Commission to abandon a market-based approach because of their perception that competition has not developed in the way anticipated by the Commission. Such arguments are nonsense. In the first instance, the starting point of the

18 Time Warner Communications, Ex Parte Presentation in CC Docket No. 96-45 Federal-State Joint Board on Universal Service; CC Docket Nos. 96-262, 94-1, 91-213 Access Charge Reform, April 1, 1997.

19 *See* "Press statement of Chairman William E. Kennard on the Second Anniversary of the Telecom Act of 1996," January 30, 1998.

market-based approach is price cap regulation. Price cap regulation was not implemented because competition was firmly established. To the contrary, it was implemented because it provides superior economic outcomes as compared to traditional cost-plus systems of regulation that would effectively be reintroduced through a prescriptive approach. The price cap system was necessary because effective competition was not in place. With such competition, a market-based approach would remove the restraints of price caps. Simply put, even if the contention that competition was not developing as expected by the Commission were correct, which it is not, there would be no reason to abandon price cap regulation. A prescriptive approach is inferior to price regulation.

The evidence betrays those who argue that competition is not developing. As Taylor points outs, competitive entry has been facilitated by the many interconnection agreements and the provision of unbundled network elements.[20] The barriers to entry have fallen and competitive local exchange carriers can easily target large business customers without having to incur substantial sunk costs. Indeed, the evidence cited by Taylor shows that CLECs have been highly successful at executing a market strategy focused on the business market, such that, for example, CLECs as a whole are adding more business lines than incumbent RBOCs.

These same competitive characteristics are evident in BellSouth's region. There is fierce competition for high capacity services with competitors capturing nearly 40 percent of the market in Atlanta and 30 percent in Florida. Competition is not just limited to high capacity services. Media One, for example, is estimated to have a 10 percent share of the local residential market in areas where it provides service in Atlanta.[21]

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20 *See,* Taylor at ¶¶ 27-36.

21 Peter Elstrom, *At Last, Telecom Unbound*, Business Week, July 6, 1998, at 24.

The focal point for the Commission, however, should be that competition continues to expand through the full range of local exchange services. As competition continues to grow, such competition will become an even more effective check on LEC pricing decisions. Until the Commission finds that competition alone is an adequate pricing constraint, price cap regulation is in place to prevent incumbent LECs from setting prices that are unreasonably high. With this system of constraints in place, the work that remains for the Commission is to adopt adaptive regulatory rules. Such rules should lift the burdens and limitations of unnecessary regulation so that competition and the marketplace are free to operate in the manner that the Commission intended as the ultimate determinant of a firm's conduct.

III. THE COMMISSION MUST CONTINUE REFORMING ITS REGULATORY APPROACH

Thus far, the principal reform aspects of the Commission's access charge reform actions have been focused on restructuring the recovery mechanisms associated with the recovery of non-traffic sensitive costs. To be sure, such restructuring was absolutely essential and needed to be accomplished in order to have a proper base from which to address regulatory reform. While the term pricing flexibility has become synonymous with regulatory flexibility, it must be understood that regulatory flexibility encompasses a framework of adaptive regulation whereby unnecessary rules and regulations that limit an incumbent LEC are removed as circumstances warrant.

The Commission has been hesitant in reforming regulation that directly affect incumbent LECs' market conduct. This hesitancy, however, negatively affects market performance, that is, price and output. For example, incumbent LECs are still required to seek Commission approval before tariffs for new switched access services can be filed. This approval does not constitute a substantive review of the service nor does it preclude the Commission from exercising any of its regulatory authority with respect to newly filed tariffs (*e.g.*, rejection, suspension and investigation). What is the purpose of requiring pre-filing permission? The putative purpose is to determine whether the public interest is served by the new service. The fact of the matter is that the statutory scheme with carrier initiated rates and streamlined notice periods for LEC tariffs demonstrate a Congressional determination that the public interest is best served when carriers are permitted to file tariffs at their discretion.[22] Indeed, the pre-filing permission requirement is an exception to the general rule of carrier-initiated rates that has long out-lived its usefulness.

If this limitation ever had a purpose, it was grounded in divestiture and AT&T's dominance in the interexchange market at that time. By specifying the switched access rate structure and preventing any new switched services from being filed, the Commission was using access charges as a way of protecting the newly burgeoning interexchange competition. Interexchange competition has lost its fragile quality and no longer requires the Commission's cultivation. Indeed, the Commission has found the interexchange market fully competitive and has forborne from regulating its participants. Thus, whatever justification may have existed for limiting switched access services, such justification has long since disappeared. Nevertheless the regulations remain.

The effect of continuing this unnecessary regulation is to prevent incumbent LECs from introducing new switched access services that would better serve the needs of its customers, provide greater value, and lower effective prices. Thus, access market performance suffers not because of the absence of competition or some alleged abuse of market power by an incumbent LEC, but instead because the Commission continues to micro-manage the offering of switched

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22 *See* 47 U.S.C. § § 203-204.

access services. The diminution of market performance is directly tied to a failure to reform regulation.

It is the failure to remove unnecessary regulations that access charge reform should address. Not only should the Commission eliminate those regulations that clearly no longer serve a legitimate purpose but also it should establish an adaptive regulatory approach that would automatically relax regulation as market conditions warrant. Bell Atlantic's and Ameritech's pricing flexibility proposals are directed to the need for an adaptive regulatory approach. BellSouth's primary interest is that the Commission take affirmative steps to achieve an adaptive form of regulation. USTA has identified the metrics that should define points where a given regulation or set of regulations should be relaxed. In the rapidly changing environment, it is incumbent upon the Commission to take the steps now so that its regulations can keep pace with the marketplace changes.

IV. CONCLUSION

The questions regarding the X-factor, prescriptive approach and pricing flexibility all distill to a single issue—how can market performance be improved? There is substantial evidence that market forces can achieve the Commission's objectives of assuring reasonable prices and the availability of a wide variety of services. In order for these goals to be achieved, the Commission will have to assure that its regulations do not get in the way and encumber the progress that would otherwise be made. Reforming regulation should not be considered an opportunity to re-regulate. The Commission should make clear its commitment to market-based solutions and put all participants on notice that the deregulatory framework of the Telecommunications Act of 1996 includes incumbent LECs.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I do hereby certify that I have this 26th day of October 1998 served the following parties to this action with a copy of the foregoing COMMENTS by hand delivery or by placing a true and correct copy of the same in the United States Mail, postage prepaid, addressed to the parties listed below.

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